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HOW PRO'S PLAY LOAN-TO-OWN GAME

Pricing and Buying Distressed Debt

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In the mergers and acquisitions market, the heady deals of just three years ago have disappeared. But in their place a frothy new market has emerged, and, as always happens in down economies, it is one in which true fortunes can be made. Bull market fortunes can turn out to be made of mere paper, but bear market fortunes are forever.

Investor money has been flooding into "distress" funds since at least 2008, and over the last six months, funds have begun deploying money much more actively. For the acquirer willing to navigate the straits of distressed investing, the worst of times can present the best of opportunities.

There are numerous ways to acquire a company, and in the distress world, one of the favorite strategies used by experienced buyers is the "loan to own" game, where the would-be-buyer purchases the debt of the target company and then launches a quick take-over play for the target's assets.

In most situations, the biggest risk in the loan-to-own game is that the borrower will file bankruptcy. A successful bankruptcy can block a take-over and leave the debt purchaser stuck holding the debt for many years. If the debt purchaser miscalculates this risk and overpays for the debt, the results can be, well ... let's just call it "enlightening."

Funds and companies experienced in distressed acquisitions have learned how to handicap and price this risk. How do they do it? What follows is an outline of one method for handicapping distressed investments – a system that would-be loan-to-own players can use to calculate the high-end and low-end price range for distressed debt, and using these as reference points, negotiate a reasonable price for distressed debt.

Consider the following example: A large, recently constructed assisted living and memory care facility is struggling. The facility, which is owned by a not-for-profit entity, owes bank debt of $20 million secured by a mortgage on the property. The facility also owes vendor debts of about $1 million, and does not generate enough cash to pay for both its operations and its debt service. The secured debt is personally guaranteed by some of the non-profit's officers and directors.

Your fund (or company) is interested in buying the struggling facility, because if acquired at a distressed price, there is significant upside in the facility. The facility cannot cash flow with its current debt load, but if acquired for $13 million or less, it could become the new flagship facility in your portfolio.

You have been negotiating a potential purchase with the target company to buy its assets, but the bank, running for the exits, has now offered to sell its debt to you for $10 million, a 50% discount off of the amount owed. How do you decide whether to buy the debt, and what to pay for it?

Why Buy the Distressed Debt?

When trying to buy in the distressed market, it is important to understand that there are essentially three strategies to acquire a struggling target company:

1. the asset purchase - acquiring a target company or its assets at a short sale, a foreclosure, or a bankruptcy sale;
2. the debt purchase - acquiring a target company's debt in order to convert it into ownership of the company's assets (the "loan-to-own" strategy); and
3. the equity purchase - acquiring a target company through a stock pledge foreclosure or a bankruptcy equity auction, and then usually reorganizing the company through bankruptcy or swapping debt into controlling equity.

With three potential strategies to acquire the target, why does the proposed acquirer sometimes decide upon buying the debt of the target company? There are several reasons.

First, it is important to understand the "credit bid." If the acquirer buys the secured debt and then pushes forward with foreclosure of the facility, the acquirer can bid the full amount of the debt at the foreclosure to acquire the facility, without having to come out of pocket a single additional dollar. The theory is that the acquirer already owns the debt secured by the facility, so it is simply giving credit against the debt when it bids.

Most importantly, the acquirer gets to bid the full amount of the debt, not the amount that it paid for it. So, using our example, if the acquirer buys the debt, the acquirer has paid $10 million to the bank to step into its shoes as the secured lender. At the foreclosure sale, it can bid $20 million for the assets – the full amount of the debt – as a "credit" against the debt. By buying the debt at a discount, the acquirer has essentially gotten an additional $10 million of buying power at no cost. We often refer to this as the "credit bid bump," which "bumps up" the potential bid from the amount the acquirer paid for the debt to the total amount of the debt. Getting the "credit bid bump" is one of the major

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reasons for buying distressed debt.

A second reason to buy the distressed debt is to prevent other interested acquirers from getting the advantage of the credit bid bump.

Third, buying debt mitigates one of the major risks in a distress purchase, the reality of limited due diligence. A buyer of distressed assets often has to make a purchase decision in a short amount of time with limited access to information. But by "becoming the bank" in a debt acquisition, the acquirer gets access to all of the information the bank has and additional access to the borrower to get information. The acquirer becomes the beneficiary of the borrower's regular reporting obligations under the loan documents. Of course, the acquirer already owns the debt at this point, so if diligence discloses a problem, it may not be able to resell the debt in the market without taking a loss; but it may be less of a loss than had the acquirer purchased the facility outright without the information.

Fourth, if the acquirer buys the bank's loan at a low enough price, the acquirer also can effectively build its transaction expenses into the deal, because it potentially has the ability to sell the debt later at a higher price, or to use the "credit bid bump" as an offset against its expenses.

Fifth, and most importantly, buying debt gives the acquirer a place at the table in all negotiations, and a level of control. A would-be buyer of a target company cannot force an unwilling seller to the table, but a lender with a defaulted loan can force a sale by calling a default and noticing foreclosure. The lender also is always a party to any negotiations and is regularly in contact with the borrower regarding the borrower's intentions.

As a result, buying distressed debt can give a would-be purchaser significant advantages in the right acquisition. These advantages can turn a mediocre acquisition opportunity into dramatic (even astronomical) investment returns.

Of course, owning the debt is never the same as owning the asset – the acquirer will have to convert the debt into ownership of the facility. The acquirer usually does this through one of the following methods: (i) accepting the property in cancellation of the debt (a deed in lieu), (ii) purchasing the property at foreclosure, (iii) purchasing the property in a bankruptcy sale, or (iv) converting the debt into equity in the company, usually as part of a bankruptcy, so that the debt holder now has the controlling stake, or maybe all, of the equity in the reorganized company. These are the four major loan-to-own strategies.

If unsuccessful in executing the loan-to-own strategy, the would-be acquirer could end up stranded in the role of lender, having to accept payments on the debt for a very long time. This could happen when the borrower makes a defensive bankruptcy filing, or where there are problems with the loan documents that prevent enforcement. Unlike a spurned asset buyer, who can simply walk away and invest its funds in another deal, a debt purchaser is inextricably tied to the borrower and must see the process through until an exit becomes available. Here lies the risk of the distressed debt purchase.

Pricing the Distressed Debt Purchase

So what is the pricing model for determining whether to buy the $20 million in distressed debt against the senior living facility, and whether a 50% discount is a reasonable price? A buyer should model the best-case and worst-case financial outcomes, adjust them based on risk, and then determine a blended price somewhere in the middle considering risk tolerance.

The range is calculated like this:

Best-case scenario: The highest price you would pay for the assets of the target itself, rather than the debt of the target. This number should be reduced by the costs of the easiest feasible loan-to-own strategy to convert the debt into ownership, and the time value of money to execute the strategy in the shortest feasible time anticipated.

Worst-case scenario: The amount you would recover in a bankruptcy "cramdown" scenario – where the borrower is able to get the bankruptcy court to block a sale and force the secured lender (i.e., you, if you decide to buy the debt) to accept payments over time, essentially forcing the buyer into the role of a long-term lender. In a cramdown scenario, the lender receives the value of the collateral, paid over a reasonable period of time for similar loans, at a commercially reasonable interest rate under the circumstances (the "cramdown recovery amount"). Realize that in a cramdown, the lender receives the value of the collateral, not the debt; the time period for similar loans is usually somewhere between five and 20 years, with the start date for the "new" loan being the date of the bankruptcy, not the original date of the loan; and the "reasonable" interest rate is almost always lower than the actual contract rate. So in most scenarios, the principal balance will be reduced, the amortization will be stretched and the interest rate will be lowered.

After determining the likely cramdown recovery amount, you then reduce this number by the likely transaction costs for what turns out to be an unsuccessful loan-to-own play and the time value of money for the anticipated period of time of the bankruptcy. Interest usually begins accruing only after the bankruptcy, when the borrower begins making payments under its plan of reorganization.

Using this range, you can then arrive at a realistic price and determine whether a debt purchase is the best strategy. The

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realistic price is the point between the best-case and worst-case scenarios that is consistent with the buyer's tolerance for risk, and available information about the most likely outcome.

Performing the Analysis to Arrive at the Price

So what are the factors that a would-be debt buyer should consider to determine the realistic price?

Perfection/enforcement risk: First and foremost in any debt purchase is a detailed review of the loan documents, and an enforcement analysis. Consider, among other things:

- Collateral and perfection risk: Do the loan documents do what they are supposed to do? Do they provide for liens in all of the assets that the buyer will need to operate the facility? Are the liens properly perfected? A lien in all of the hard assets of the debtor is not necessarily enough. The buyer often needs a lien in intangibles also, such as licenses and contracts, in order to make an acquisition successful.
- Validity risk: Are there any waivers in the correspondence given by the prior lender of the existing defaults, or any forbearance agreements that prevent foreclosure? Are there any inherent problems with the loan documents, like the interest rate being usurious, or loan fees charged against the borrower that are unreasonable and uncollectible?
- Enforcement risk: Do the loan documents provide adequate remedies upon default, including the right to appointment of a receiver? Looking at the law of the state where the facility is located, how long will it take to achieve a foreclosure of the asset? Does the state allow an out-of-court foreclosure, or does it require a judicial foreclosure which must be initiated in a lawsuit?

In New Jersey, for example, commercial foreclosures usually take more than a year. A smart borrower playing for time will wait until a few days before the foreclosure, or even the morning of the foreclosure, to initiate a bankruptcy. That means that pursuing an asset in New Jersey can take several years of litigation – more than a year leading up to the foreclosure, and then time litigating in the follow-on bankruptcy.

- *Regulatory enforcement risks*: Where a non-profit is involved, what does state law where the facility is located provide about the ability to sell the assets of a non-profit at foreclosure, to a for-profit buyer? This may constitute a not-for-profit to for-profit conversion, requiring special clearance from the state attorney general. In the case of accounts receivable, are any of the memory care patients paid for by Medicare/Medicaid dollars? If so, realize there may be a legal prohibition against the buyer collecting these dollars directly from the government in the absence of a court order, and collection will require advance planning.
- *Assignor/assignee risk*: Did the prior lender overreach or commit any potentially illegal actions? By stepping into the shoes of the lender, it is possible that you as the buyer could take liability for these issues. Also, if there is a bankruptcy filing within 90 days of the debt purchase, and the prior lender received money during that period which is recoverable as a "preference payment" in bankruptcy, it could prevent you as the debt buyer from being able to enforce your debt in bankruptcy until the "preference" is repaid.
- *Debt class risk*: Is the debt being purchased a bank loan, or does it consist of bonds? A purchaser of distressed bonds will have more difficulty with a credit bid unless the purchaser owns all the bonds. Otherwise, the purchaser will become the owner of the facility with the other bondholders, who may not want to credit bid. Is the debt being purchased a syndicated credit facility, where the buyer will have obligations to other lenders, or will be a partner with other lenders? Is the debt senior secured, junior secured, or unsecured? Only a senior secured creditor has the right to credit bid at the beginning of a sale and erase the other debts; junior secured debt must first pay off the senior debt before it can begin using its debt to credit bid.

Cramdown risk: The major risk that any debt buyer faces is cramdown risk in a bankruptcy, where the debt buyer is unable to force a sale, and instead, is required to receive repayment of the debt at a reduced amount, re-amortized over more time, at a lower interest rate. In analyzing cramdown risk, the debt buyer should consider the following:

- *Cramdown recovery amount analysis*: If the borrower is successful at achieving a cramdown, what is the anticipated cramdown recovery amount? This requires an analysis of the likely current value of the collateral, the borrower's available cash to pay debt service on a debt which equals the value of the collateral, and a comparison of current interest rates to the interest rate provided in the loan documents.
- *Cramdown reorganization risk:* Achieving cramdown in a bankruptcy is no easy feat for a borrower, because the lender has a number of defenses. In order to get a cramdown plan approved, a borrower

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must meet numerous criteria under the bankruptcy code. The lender should consider each, and whether the lender is likely to be able to obtain a blocking position:

- *An impaired class of creditors that will vote in favor of the plan:* a borrower must have at least one class of creditors vote in favor of any plan of reorganization, and the class must consist of creditors who are not being paid in full. If there are unlikely to be any such creditors, or the lender has a large deficiency claim that is likely to control the voting in the class, then the risk of cramdown is less. If the lender is willing to spend additional money to buy up the claims of other creditors in order to get a blocking position on any vote, this can be a very strong defense.
- *The absolute priority rule:* in bankruptcy, the equity in a company is usually cancelled unless all classes of creditors are paid in full. The usual way that existing owners prevent the loss of their control of the company is by having an auction at which they sell equity in the newly reorganized company (and attempt to buy it themselves for a nominal new investment), or by allowing other parties to propose competing plans of reorganization. If the debt buyer is prepared to bid at the equity auction, or to put on its own plan of reorganization, it may be able to prevent a cramdown.
- *Financial feasibility of any potential reorganization plan:* the borrower will have to show that its plan of reorganization and repayment of the cramdown recovery amount is feasible. A debt buyer can analyze the borrower's financial performance to determine how likely it is that the borrower will be able to make reasonable payments on the restructured debt. A buyer with little cash available for debt service, and no easy way to change its operations to achieve this, will have difficulty reorganizing. The borrower must also have sufficient cash to pay the expenses of the bankruptcy (and the borrower's bankruptcy professionals) immediately upon emergence from bankruptcy. This can be a significant hurdle.
- *Other factors:* There are a number of other factors that a debt buyer should consider, such as whether there are other substantial creditors. If not, this could help in achieving early dismissal of the bankruptcy, in order to return to the foreclosure process. The type of asset class at issue may present other factors. A single-asset real estate case, for example, is more likely to be dismissed or settled quickly. A health care case, on the other hand, involves patient-care issues, as well as a potential bias in favor of continuing non-profit care in the locality.

Successor liability and "leverage" risk: In addition to cramdown risk, there is additional litigation risk that needs to be considered, and "hold-out" risk if creditors who are essential to the operation are unwilling to play ball with the buyer. These risks are not specific to a debt purchase, but are inherent in all distressed purchases. Examples of these risks are:

- *Successor liability:* Are there litigious creditors who are likely to sue the buyer? Creditors of a defunct company will sometimes try to pursue the buyer of the company's assets on the theory that the buyer is a mere continuation of the prior entity. Bankruptcy and foreclosure sales help to minimize this risk, but it is important to analyze the law of the state where the assets are located. Also, are there sales, unemployment tax, payroll, or payroll tax liabilities of the borrower? Some states provide that a buyer has automatic successor liability.
- *Leverage risk:* Are there essential suppliers to the business who are unwilling to continue supplying the buyer after the purchase unless the buyer pays their past balance in full? In the absence of a bankruptcy sale and a binding contract, suppliers are allowed to use this leverage, and it can be very costly for the buyer. In some situations, it could shut down the newly purchased business. Are there government agreements, such as Medicare and Medicaid provider agreements that must be assumed as part of the purchase? The government generally requires that a buyer taking these agreements assume all past liabilities related to them.

Diligence risk: A debt purchaser planning to execute a loan-to-own strategy has virtually all of the normal due diligence issues involved in purchasing the asset itself. But time is short, and information is limited. Consider:

- *Real estate diligence:* A buyer's due diligence usually needs to include a property survey, environmental analysis, title insurance, zoning, and easements analysis. If the buyer has limited ability to obtain these, the distressed debt price is usually adjusted downward because of increased risk. Consider also baseline risks that might be associated with a specific property: what if the senior living facility is owned by a church whose members are the primary residents? The church may have little incentive to act as a feeder for occupancy after an ugly foreclosure battle. These kinds of

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issues can be critical to the future success of the facility.

- *Financial diligence*: The usual financial diligence that goes into modeling the future performance of a facility after an acquisition, and the costs to turn it around, is customary. The acquirer also must consider bridge funding risk – the potential problem of having to fund the borrower's operations through a sale if it cannot pay its operating expenses.
- *Operational diligence*: A purchaser will want to investigate the operations of the facility, and the quality of its services, as well as any regulatory and licensing issues.

The Senior Living Example – to Buy Or Not to Buy?

Using the senior living facility as an example, should you buy the debt, or continue your efforts to buy the facility at a potential foreclosure or bankruptcy sale? In abbreviated fashion, the analysis could look like this:

Best-case scenario price: You have information that the borrower's management may be willing to walk away if they can get released from guarantees. You would be willing to pay $13 million for the assets at a sale, and you anticipate that the cost and time value of money to get there – to conduct a friendly foreclosure in the state where the facility is located – is approximately $500,000. Your best case scenario price for the distressed debt is $12.5 million.

Worst-case scenario price: After review, you believe the facility is worth approximately $11 million, and you arrive at a present value cramdown recovery amount of $9 million based on assumptions of a poor financial performance, current interest rates and your transaction costs (including time value of money). Your worst-case scenario price for the distressed debt is $9 million.

Realistic price: Your fund has a high risk tolerance, because it does numerous distressed debt purchases and is diversified, so it can afford to have some winners and some losers when it purchases distressed debt. In addition, based on current information about management, you think that a voluntary bankruptcy filing is unlikely. The company is a non-profit, so there is no risk of an involuntary bankruptcy filing by creditors. This brings you to a realistic purchase price for the distressed debt of approximately $11.5 million. The lender is offering the debt at $10 million, making this a good deal.

You buy the debt, and working with management's cooperation in exchange for a release from guarantees, you foreclose the property at auction. Three competitors appear at the foreclosure auction and bid the price up to $17 million. You bid $17.1 million as a credit bid against your debt, and acquire the facility. Your price? $10 million, plus some transaction costs, because as the owner of the distressed debt you got the "credit bid bump." Buying the debt here saved you approximately $7.1 million, dramatically increasing your potential for return on investment.

Conclusion

Distressed acquisitions are likely to shape the market over the next few years, and with three primary distressed acquisition strategies, the distressed debt play can provide significant opportunities. The U.S. market is especially favorable for distressed debt purchases, because the U.S has well-developed law and a clear preference for keeping companies intact as the best way to preserve jobs. As the economy continues to shift, opportunities will abound for the savvy loan-to-own buyer in the distress market.

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